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World Economic and Social Survey, 1998*

Chapter I

The world economy in 1998

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Chapter I

The world economy in 1998

The 1990s have been the era of globalization, when rapid growth of international trade and financial flows affected more and more economies in deeper and deeper ways. The benefits of financial globalization, in particular, have been many, but the world economy has periodically been buffeted by international financial shocks, the latest of which has been the most severe. It can be regarded as having begun when the Thai baht collapsed on 2 July 1997, after which it spread to other Asian economies and has since touched countries on every continent in one way or another.

The crisis has plunged several of the fastest growing economies in the world into a severe recession and slowed the growth of world output and trade. Individual countries in crisis are facing steep social costs which may be long-lasting, and difficult recoveries from their depressed economic conditions. This time – it is the third major currency crisis in five years[1] – widely held beliefs about how the international system works, and in particular about the desirability of fully liberalized financial markets, have been profoundly shaken.

The crisis showed that one of the most competitive markets in the world, the international market for financial assets, could fail in a major way. The failure was at multiple levels, including failures of official oversight. The latter involved the Governments of the crisis countries, which did not prevent their financial sectors from taking on excessive high-risk exposures as they liberalized their capital markets; but it also included weak international oversight of financial markets, where effective cooperation among the major regulatory authorities lagged behind the rapid developments in international finance.

What is most needed at this time, according to a growing number of experts, is not more decontrol and deregulation, but more effective official oversight and market-based controls of financial markets. However, there is no consensus on how to achieve this, although there does seem to be a consensus that great care must be taken in designing how to intervene in the market and how to balance incentives and restrictions. As requested by the General Assembly (in its resolution 52/180), some proposals in this regard are offered for discussion in the second section of the present chapter.

A surging world economy faces a slowdown

Earlier editions of this *Survey* and other periodic assessments of the state of the world economy by the United Nations Secretariat suggested that the world economy had attained a "cruising speed" of about 3 per cent per year growth in world output. By 1994, the world economy had come out of the recession of the early 1990s, and by 1997 world output grew 3.3 per cent, the fastest rate of growth since the late 1980s (see table I.1).[2] In addition, the total output of all three major groupings of countries grew for the first time in the decade. The volume of world trade, whose growth had slackened in 1996 from the rapid rates in 1994 and 1995, picked up again in 1997, when it expanded by 9 per cent.

[1] The first was the crisis of the Exchange Rate Mechanism of the European Union in 1992; and the second was the Mexican crisis and the "tequila effect" in 1994-1995.

[2] For comparative purposes, table I.1 includes an alternative measure of the growth of world output which is employed, in particular, by the International Monetary Fund (IMF) in its *World Economic Outlook*. This measure weights countries differently when calculating the regional and global averages (see introduction to the statistical annex for additional details).

Table I.1. Growth of world output and trade, 1981-1998
(Annual percentage change)

	1981-1990	1991	1992	1993	1994	1995	1996	1997[a]	1998[b]
World output[c]	2.8	0.8	1.7	1.3	2.9	2.5	3.2	3.3	2½
Of which:									
Developed economies	2.9	0.7	1.6	0.8	2.7	2.1	2.6	2.7	2¼
Economies in transition[d]	1.6	-8.2	-13.2	-9.3	-7.1	-0.8	-0.0	2.7	3½
Developing economies	2.4	3.2	5.0	5.2	5.6	4.6	5.7	5.8	3¾
World trade[e]	4.5	4.3	5.7	4.6	10.5	8.6	5.5	8.9	7
Memorandum items:									
Number of countries with rising per capita output	106	70	74	68	99	109	121	123	127
Number of countries in sample	127	128	142	143	143	143	143	143	143
World output growth with PPP-based weights[f]	3.1	1.1	2.0	2.3	3.7	3.4	3.9	4.1	3¼

Source: UN/DESA.
[a] Partly estimated.
[b] Forecast, based in part on Project LINK.
[c] Calculated as a weighted average of individual country growth rates of gross domestic product (GDP), where weights are based on GDP in 1993 prices and exchange rates.
[d] Based on reported GDP, which underestimates activity in several countries.
[e] Average of growth rate of the volume of exports and imports.
[f] Employing an alternative scheme for weighting national growth rates of GDP, based on purchasing power parity (PPP) conversions of national currency GDP into international dollars (see introduction to statistical annex).

The outlook for 1998, however, is different. The growth of output is slowing down in both developed and developing countries, while the growth of world trade is also decelerating. World output is forecast to grow by about 2½ per cent, almost 1 percentage point less than in 1997. Moreover, an unusually large degree of uncertainty surrounds this forecast. The uncertainty is overwhelmingly on the down side, implying that the slowdown could be even more severe (see box I.1). Indeed, like other official and commercial forecasters, the Secretariat has already lowered its outlook on the prospects for 1998, as the crisis continues to unfold in ways that neither econometric models nor extrapolations of trends could predict.[3] Whatever the precise final outcome, it is clear that 1998 is a year of major disruptions in the world economy.

In particular for most developing countries, the international economic environment has become less propitious in 1998. As discussed in chapter III, the prices of many primary commodities have slipped, most notably that of crude petroleum. In addition, exports to the formerly dynamic Asian markets have suffered, as these countries have had to curtail their imports as part of their adjustment process. Also, stagnating domestic demand in Japan has seriously curtailed exports to that country.

[3] In its previous outlook, the Secretariat forecast that world output growth would slow half a percentage point, compared with the drop of almost a full percentage point in the current outlook (see the report of the Secretary-General entitled "The world economy at the beginning of 1998" (E/1998/INF/1)).

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Box I.1. Postscript on the deteriorating economic outlook

The world economic situation has deteriorated since work on the outlook for 1998 was completed (30 April 1998). Changes since that time are concentrated almost entirely in the outlook for the developing countries, especially in Asia. As of mid-June 1998, we would not materially change our forecast for Japan, as the weak start to the year in that country had been anticipated.

However, our forecast may have overstated economic growth prospects in the Russian Federation. The Russian situation in 1998 exemplifies the contagion effect of the Asian crisis, as financial markets seek out and act on the perceived weaknesses in economic conditions and policies, to which they were less sensitive in earlier times, that are discouraging capital inflows and domestic investment; but even if there were no growth in the Russian economy in 1998, the economies in transition as a whole could still post an average growth rate of about 3 per cent.

Among the developing countries, the largest changes would be in East Asia itself, although there would be some downward revisions in the outlook of various regions as a result of the further fall in oil and other commodity prices, partly reflecting lower demand than expected in Asia. Instead of the small but positive growth of output shown in tables II.3 and A.4, a revised forecast would likely show a decline in output, reflecting the recessions in Indonesia, the Republic of Korea, Malaysia and Thailand. Another unexpected development is that, following nuclear tests by India and Pakistan, sanctions were imposed by some countries. That these sanctions would block anticipated official financing from several major donors could slow India's and Pakistan's economic growth, beginning in 1998. All in all, the average growth rate of the developing countries could fall to 3 per cent in 1998.

On the basis of the above considerations, world output growth would weaken more than anticipated earlier, albeit not by enough to change the "rounded" forecast of 2½ per cent shown in table I.1. By the same token, world trade growth may also be less than the April forecast, but by how much it is impossible to say at this time.[a]

[a] The next LINK forecasting exercise is scheduled for September 1998, after which a report will be issued and posted on the Internet home page of the Development Policies Analysis Division, Department of Economic and Social Affairs of the United Nations Secretariat (www.un.org/esa.analysis/ddpa.htm).

Moreover, there was a dramatic change in the net transfer of resources of the developing countries. In 1996, they had a net deficit of $8 billion in their balance of trade in goods and services and thus were net recipients of financial transfers of $8 billion to finance this deficit. In 1997, the developing countries made a net transfer of financial resources abroad of almost $27 billion, the first "negative transfer" since 1990 (see table III.1). The net transfer is not expected to improve in 1998.

In fact, data on the net transfer must always be interpreted carefully, as a negative net transfer can be a sign of economic strength or weakness, depending on whether it is brought about by an expansion of export earnings or a contraction of imports, and on whether the

transferred financial resources represent surplus domestic savings or sacrificed domestic investment. In 1997, the net transfer abroad by developing countries resulted from a combination of positive developments in some countries and negative ones in others (see chap. III for details). However, more of the negative than of the positive developments are expected in 1998, particularly as regards the crisis countries of East Asia.

Global incidence of economic growth

Despite the slowdown in 1998, the world economy still embodies significant and widely spread momentum.[4] In 1997, output per person rose in 123 countries out of the 143 that are regularly monitored. The forecasts in the *Survey* suggest that output per person will rise in even more countries in 1998 (see table I.1).

This notwithstanding, the countries in which output per capita is forecast not to rise in 1998 are bigger ones than previously. In the developed countries, where population growth is slow (averaging 0.6 per cent a year), gross domestic product (GDP) per capita was rising in all but one country in recent years (Switzerland) and thus 99 per cent of the population of the developed countries lived in countries with rising average income levels. With the stagnation of the Japanese economy in 1998 (and more rapid economic growth in Switzerland), the percentage falls to a still high 85 per cent (see table A.1 for levels and growth of GDP per capita through 1997, and table A.2 for growth rates of individual developed economies).

Per capita GDP is forecast to rise in all the transition economies in 1998, although there is considerable uncertainty about prospects in a number of them, including, notably, the Russian Federation.[5] Most countries, however, have yet to regain the income per capita levels attained before the transition began at the start of the decade. In 1997, 78 per cent of the people living in transition economies were in countries with rising GDP per capita, which was already a great improvement over the 40 per cent in 1996 – the figure had been zero in 1992 (see tables A.1 and A.3).

In the developing countries, 1996 was the year in which economic growth was spread most widely in terms of the population potentially affected. In that year, 96 per cent of the people living in developing countries were in countries with rising GDP per capita. There had been a steady rise in this share since 1991, when the comparable figure was 82 per cent. However, with the advent of significant economic slowdown or outright recession in several relatively large developing economies in 1997 (including Saudi Arabia, South Africa and Thailand) and in 1998 (including Brazil, Indonesia, the Republic of Korea, Malaysia, and Venezuela), the 1998 figure is expected to drop to 87 per cent (see table A.4 for GDP growth rates for these and other developing countries and table A.1 for regional data on GDP per capita).

Global success against inflation

One dramatic feature of the world economy in recent years has been the reduced rates of inflation. The average inflation rate in the developed economies has hovered around 2 per cent a year since 1994 (see table A.7), and the inflation rates in many transition and developing economies have come down from damagingly high levels. None of the transition economies are forecast to have triple-digit inflation rates in 1998. Eight of them are expected to post single-digit inflation results this year and inflation is expected to be between 10 and

[4] Regional and country situations are reviewed in more detail in chap. II.

[5] In the Russian Federation, where mortality rates have risen, the size of the population is falling, as is the case in several other economies in transition.

15 per cent in the majority of countries (see table A.8). In the developing countries, where the average inflation rate was 254 per cent in 1993, the average was 11 per cent in 1997 and about the same rate is forecast for 1998, despite the currency crisis in several countries (table A.13). In two large economies that had "runaway" inflation in the early 1990s, Argentina and Brazil, the annual inflation rate in 1998 is expected to be in low single digits.

The broad fall in inflation rates is primarily a result of government policies. In developed, transition and developing countries, monetary policies no longer readily accommodate demand pressures that would lead to inflation and fiscal deficits have been widely curtailed. Among the significant developments in 1997, the once-large budget deficit of the United States of America has completely disappeared (see table A.9).[6] In the European Union (EU), targets to reduce the 1997 budget deficit to no more than 3 per cent of GDP were met by all the countries seeking to enter into the monetary union. Indeed, with continuing fiscal constraint in these countries (and elsewhere), there is a growing concern that monetary policy not be tightened in advance of clear evidence that inflationary pressures have returned. The global benefits that have followed from the low inflation might be jeopardized if a number of economies were tipped into deflation, especially at this time of considerable global economic uncertainty.

Pace and spread of growth in developing economies

The difficulties in 1998 follow upon a very strong year for economic growth in the developing countries (see table A.4). Average GDP growth in 1997 reached the highest level in almost two decades. As in 1996, this was the result of significant expansion in a large number of countries, rather than very high growth in a small number of countries. Of the 95 developing countries monitored for the preparation of the *Survey*, 81 registered an increase in output per capita in 1997. This phenomenon of significant growth spread over a large number of countries is expected to continue in 1998, even with the sharp economic slowdown and substantial contraction in most countries in East Asia and the adverse contagion effects of the Asian financial crisis on economies in other developing regions. Indeed, in Africa and Latin America, all but a few countries are expected to register growth of GDP per capita in 1998.[7]

This notwithstanding, most developing countries need more rapid growth in output than that which raises GDP per capita if they are to meet important social and development goals. In many cases, a rate of growth of output that raises per capita GDP by 3 per cent a year may be considered the absolute minimum needed – and needed over a sustained period of time – in order to attain even moderate levels of income per capita within a reasonable number of years. Only 35 countries attained this rate of growth in 1997 (see table I.2). As a deceleration in economic growth is expected in many of the rapidly growing developing countries in 1998, the number of high-growth countries is expected to shrink to only 24.

[6] In earlier years, the large United States fiscal deficit had been associated with the large United States trade deficit and the large net transfer of financial resources to the United States that financed it; however, even with the budget deficit reductions in recent years and the elimination of the budget deficit in 1997, the net financial transfer to the United States has continued and even increased. In 1997, the figure reached $131 billion, the largest since 1987 (see table A.24 and the discussion in chap. III).

[7] The exceptions are Brazil, Jamaica and Venezuela in Latin America, and Burundi, the Central African Republic, the Libyan Arab Jamahiriya, Rwanda and Zimbabwe in Africa.

Table I.2. Number of developing countries with GDP per capita growth of 3 per cent or more, 1991-1998

	Number of countries monitored	1991		1992		1993		1994		1995		1996		1997[a]		1998[b]	
		N	P	N	P	N	P	N	P	N	P	N	P	N	P	N	P
Developing countries of which:	95	26	44	33	45	28	48	34	72	31	69	37	73	35	72	24	62
Latin America	24	6	16	9	20	9	27	9	56	5	17	7	33	8	37	5	32
Africa	38	6	8	8	12	4	12	8	12	7	14	14	26	12	29	8	12
East and South Asia (including China)	18	11	58	12	58	13	61	14	93	14	93	13	94	12	90	8	81
East Asia (excluding China)	12	8	66	10	88	10	88	7	87	9	87	10	99	8	76	4	26
Western Asia	15	3	8	4	32	2	29	3	3	5	33	3	35	3	37	3	37
Memo items:																	
Least developed countries	40	5	7	9	23	8	46	11	42	12	46	11	50	13	55	6	34
Sub-Saharan Africa	31	5	7	7	18	4	21	7	14	7	17	12	36	10	32	6	11

Source: UN/DESA, including population estimates and projections from United Nations, *World Population Prospects: The 1996 Revision* (United Nations publication, forthcoming).

Note: N: Number of countries that achieved the specified per capita growth; P: Percentage of total population of monitored countries in a given group accounted for by countries in this group that achieved the specified per capita growth.

[a] Preliminary estimates.

[b] Forecast, based in part on Project LINK.

In Africa, output per capita is expected to grow in 1998 in 33 of the 38 countries monitored, encompassing about 95 per cent of the population of the monitored countries. Growth has been aided by improved political stability in some areas, as well as by spreading macroeconomic stabilization and structural reform. Nevertheless, Africa remains highly vulnerable to exogenous factors, such as adverse weather conditions and deterioration in international prices of commodities. Some African countries that had attained a rate of growth of GDP per capita of 3 per cent or more since 1995 suffered a reversal in 1997 or are expected to do so in 1998 (for example, Angola, Ethiopia, Uganda and Zambia). As a result, the number of countries achieving 3 per cent growth in GDP per capita in 1998 is expected to fall to 8, a figure comparable with those in the early 1990s.

In Latin America and the Caribbean, economic growth in 1997 strengthened substantially, supported by robust investment, consumption and exports in the first three quarters of the year. Economic expansion became more widespread, extending to 21 of the 24 countries regularly monitored, constituting 97 per cent of the total population of those countries. However, the vulnerability of the economies in this region to the volatility of international financial and trade conditions is underscored by the indirect impact of the Asian financial crisis on their economic growth in 1998. The number of countries in the region forecast to attain a rate of growth of GDP per capita of 3 per cent or higher in 1998 has declined to 5, from 8 in 1997. This threatens to reverse the small reduction made in 1997 in unemployment and poverty in some countries.

In East Asia, the economic fallout of the regional financial crisis is expected to depress total and per capita output growth to the lowest level in at least two decades. Only 4 of 13 East Asian economies and China are expected to see GDP per capita grow by 3 per cent or more in 1998. Of the fastest growing economies of the 1980s and 1990s, only China and Taiwan Province of China will maintain a robust, even if slower, rate of growth in 1998.

Towards a response to international financial volatility

The confidence of international financial markets was deeply shaken by the events that had begun in East Asia in 1997 and that continued to unfold in Asia and elsewhere in 1998 (see chap. III). These events have raised worldwide concern in international organizations, Governments, financial markets and civil society at large. There is a concern about the consequences of the events themselves and about the seeming inability to resolve the difficulties. The review of the discussion on the subject contained in chapter III concludes that this is a time for humility and debate. In that spirit, the following observations on addressing the issue of international financial volatility are offered for consideration.[8]

[8] The following is an elaboration and extension of views developed over the past several years, in cooperation with the Bretton Woods institutions and the United Nations Conference on Trade and Development, as summarized in two reports of the Secretary-General on the challenges and opportunities of global financial integration (see documents A/51/388 and A/52/406). The discussion draws as well on the views presented to the General Assembly at its fifty-second session by outside experts in a series of informal meetings of the Second Committee (see *International Finance and Developing Countries in a Year of Crisis: 1997 Discussions at the United Nations*, Barry Herman and Krishnan Sharma, eds. (Tokyo and New York, United Nations University Press, 1998)); on the views of an expert group drawn from Asian and Pacific participants in the Project LINK network that met at the Department of Economic and Social Affairs on 17 and 18 March 1998; and on the views expressed in the special high-level meeting of the Economic and Social Council on 18 April 1998 with representatives of the intergovernmental bodies of the Bretton Woods institutions.

Macroeconomic policy in a financially integrated world

The standard goal of macroeconomic policy is to establish and maintain a low-inflation, growth-oriented and sustainable economic environment. The tools usually applied for these purposes are monetary policy (with primary attention given to interest rate changes) and fiscal policy (usually with a focus on the central government budget position). However, fiscal policy is not easily manipulated for macro-policy purposes and the power of monetary policy has been diluted by the increasing range and sophistication of financial instruments and international financial integration. Monetary policy is particularly weakened when a country seeks to maintain a fixed exchange rate with liberalized capital inflows and outflows.

The experience of developed countries has indicated that when monetary authorities alter short-term interbank lending rates, the degree to which changes in these rates lead to changes in the overall credit conditions that enterprises and individuals face is lessened by increasing financial development and innovation. The aim of monetary policy in developed countries is thus, increasingly, to steer the financial system along a smooth medium-term course using the rather small rudder available, instead of attempting to guide short-term movements of monetary conditions.[9]

To some degree, a similar phenomenon has been occurring in developing countries. Many countries have traditionally fixed their exchange rates and controlled financial inflows and outflows. Now, increasingly sophisticated financial markets offer more and more ways to bypass foreign exchange controls. Even more than in earlier times, capital controls today should be viewed as an impediment that can be overcome at a cost, rather than as an insurmountable barrier. Perhaps with this in view, developing countries, like the developed countries before them, have been relaxing controls and freeing capital movements.

Monetary policy in this less controllable environment can pose great challenges. It can even work perversely. In particular, if the monetary authorities seek to curtail the growth of spending by raising domestic interest rates, making them significantly higher than foreign ones, and if the political commitment to maintain the exchange rate at its existing parity is credible, then there is a great incentive for foreign funds to flood in and finance greater domestic spending. Such situations have fed foreign debt-financed spending booms and allowed unsustainable external deficits on current account to arise in certain cases. A further tightening of monetary policy, other things being equal, only worsens the situation, until debt-servicing burdens become excessive, credit is withdrawn, the exchange rate has to be devalued and the country enters into recession and an adjustment period.

On the other hand, fiscal policy may be seen as a tool that could be more effective than monetary policy in curbing excessive aggregate demand in a liberalized financial environment with a fixed exchange rate. Even more so than monetary policy, however, fiscal policy is not a tool of choice for short-term demand management in most situations.

Governments should establish their spending and taxing priorities and thus their annual budgets for sound reasons of public policy. Governments might then accelerate or retard outlays for investment programmes or raise and lower taxes to a degree in order to counter short-term changes in aggregate demand. However, there are particular interests at stake in each fiscal change and thus the political dimension for changes in fiscal policy is much closer to the surface than for changes in monetary policy. The political question is even more

[9] On this and limits on fiscal policy, see *World Economic and Social Survey, 1995: Current Trends and Policies in the World Economy* (United Nations publication, Sales No. E.95.II.C.1), chap. IV, entitled "Limits of macro-policy in industrialized countries".

acute if the Government has to cut expenditures or raise taxes when there are no indications that the fiscal deficit itself is unsustainable.[10] This was the case, in particular, in the adjustment programmes of the Asian crisis countries.

In short, a degree of financial market development and capital-account liberalization combined with a fixed exchange rate appears to leave a country with a limited capacity for macroeconomic management. In such situations, Governments might wish to consider whether to re-impede the free movement of the more volatile components of international capital flows and/or introduce greater flexibility in their exchange rates. Chile is an example of a country whose Government has done both.[11] It does not follow, however, that Governments would necessarily choose to limit the degree of liberalization or make their exchange rate more flexible, as they might agree to live with a lower degree of control over their domestic macroeconomic situation.[12]

Exchange-rate strategies for "emerging market" economies

The traditional practice in many countries has been to fix the exchange rate with the aim of reducing the uncertainty about exchange-rate developments in order to foster trade and financial flows. In today's world of highly integrated and quickly responding international financial markets, however, allowing market forces to regularly move the exchange rate may be more appropriate than fighting costly and quixotic battles to prevent its movement.[13]

The greater uncertainty about the future exchange rate would foster the development of hedging instruments in all but the smallest currency markets. For a cost, forward markets in foreign exchange would remove the exchange-rate uncertainty over short time periods. The forward rate would be free to differ from the current spot rate and a growing forward discount on the spot exchange rate (assuming interest rates remained unchanged) would be an indication of expected future depreciation of the spot rate.

When a country decides to adopt a fixed exchange rate, the typical method has been to peg the rate to a specific currency or basket of currencies, with the central bank entering the market to buy or sell foreign exchange whenever the market moves the exchange rate to the edge of an announced band around the peg (say, plus or minus 1 per cent of the exchange-rate peg). A variant of this method is to allow a wider fluctuation band (say, plus or minus 10 per cent). The latter introduces a measure of uncertainty, as long as the exchange rate does not approach the edge of the fluctuation band. At that point, the exchange rate is not allowed to continue moving away from the peg and it becomes, operationally, little different, for one-way changes, from a peg with a narrow band. In either case, the band is

[10] On the sustainability of fiscal positions and other dimensions of fiscal policy, see *World Economic and Social Survey, 1997: Trends and Policies in the World Economy* (United Nations publication, Sales No. E.97.II.C.1 and corrigenda), part two, entitled "A perspective on fiscal adjustment".

[11] See Manuel Agosin and Ricardo Ffrench-Davis, "Managing capital flows in Latin America", United Nations Development Programme, Office of Development Studies, discussion paper, No. 8, pp. 12-18.

[12] For example, Argentina, in an already liberalized capital environment, opted in the early 1990s for a passive monetary policy when it adopted it's currency board, under which Argentine interest rates largely follow those of the dollar, to which the Argentine peso is pegged (see *World Economic and Social Survey, 1997* ..., chap. VII, sect. entitled "Credibility built from failure: Argentine policy in the 1990s").

[13] If the national preference for exchange-rate stability is very high, an alternative policy is to permanently fix it, as is the case for countries adopting currency board systems, or to abandon the national currency entirely, as is being done by the countries that will enter the single currency area of the European Union (on the latter phenomenon, see chap. III).

as credible as the resources of the central bank and its willingness to buy or sell the foreign exchange necessary to absorb the excess supply or demand at the edge of the band.

A different approach would be to deliberately introduce uncertainty about the commitment of the monetary authority to any particular exchange rate. The simplest method is to let the exchange rate "float". The central bank need not be totally passive and could intervene to smooth short-term fluctuations in demand and supply and thus in short-term exchange-rate changes (this is called a "dirty float").

Policy makers could still decide to guide a floating exchange rate; for example, the monetary authority could announce an exchange-rate target, while also announcing that it would not necessarily act to prevent significant, albeit temporary, departures from that exchange rate. Such targets, like target rates of inflation or growth of the money supply, would give the business and financial community a view on the Government's policy intentions, without firmly committing it to a particular outcome at a particular moment.[14]

In addition, a variety of techniques have been discussed in the literature that could complement this approach. One class of proposals would discourage short-term capital inflows through a tax or its equivalent, so designed as to impinge more heavily on short-term flows than on longer-term ones. While the version of this policy that has been most discussed in the academic literature and in the press is the "Tobin tax",[15] the variant that has been discussed in the most positive light is the Chilean system. Its core idea is reflected in the requirement that foreign financial investors in Chile place a stipulated proportion of their capital inflow into non-interest bearing deposits with the central bank for a stipulated period, regardless of how short a time they keep their funds in the country.

The Chilean method has been compared to "throwing sand in the wheels of international finance". The image is meant to denote the slowing of the speculative flows. By the same token, exchange-rate flexibility could be compared to "throwing uncertainty into the wheels of international finance".[16] Additional methods have been suggested for raising the perceived cost of speculation and further research into and discussion of them are required.[17] These policies are intended to serve as the defensive measures that individual countries could take in order to lessen their vulnerability in a world of volatile international capital movements.

Financial-sector strategies for a volatile world

Experience after experience in international finance points to the potential volatility of international financial flows, especially short-term credit flows and portfolio investment. The need for governmental authorities to maintain a robust financial sector is paramount, but special considerations apply when the country liberalizes its capital account and

[14] This would also discourage one-way bets on devaluation in times of stress, as the currency would move immediately in response to the initial stress, thereby relaxing it, at least in part.

[15] See, for example, *The Tobin Tax: Coping with Financial Volatility*, Mahbub ul Haq, Inge Kaul and Isabelle Grunberg, eds. (New York, Oxford University Press, 1996).

[16] Richard Portes, who uses the term, attributes it to a British colleague, David Begg.

[17] One such proposal is for policy makers to discuss in an international forum the conditions under which they would tacitly approve a well-defined "standstill" on repaying foreign loans. It would function in the manner of the "circuit-breakers" introduced in stock markets, whereby rules are established according to which trading is temporarily halted when prices fall by more than a pre-set amount. The standstill period would allow the Government time to design a corrective policy programme in cooperation with IMF. Meanwhile, the foreign creditors would not be able to recoup their funds. Knowing that this might happen would raise the riskiness of short-term flows, particularly during a time of stress on the balance of payments.

increases the access of its banks and enterprises to foreign funds. In this environment, how does a Government reduce vulnerability to a change in sentiment of foreign creditors and the sudden withdrawal of funds?

A first answer is to reduce the likelihood that the local financial institutions that intermediate the most volatile components of financial flows will themselves become poor credit risks and discourage foreign financing or prompt its removal. Primarily, this involves ensuring that local banking institutions that borrow abroad or take deposits from foreign sources are sound. Thus, developing and transition economies need to monitor explicitly and closely the exposure to foreign risk of their financial institutions and prevent the risk from becoming excessive.

One technique for limiting risk exposure is for the banking authorities to impose a specific capital reserve requirement on each financial institution against its foreign deposits or liabilities. The level of the required reserves of an institution might be increased disproportionately with a growing foreign currency exposure of the bank. The level might also be adjustable and changed by the authorities whenever they wished to limit further or permit an expansion of the aggregate exposure.[18]

This approach would reduce the probability of excessive exposure of individual institutions or the commercial banks as a whole. However, the aggregate exposure of the country could still become excessive, as non-financial enterprises from the country might borrow directly from foreign banks or other sources, and hence would elude the eye of domestic financial regulators. In addition, there are indications that some enterprises in the 1997 crisis countries did not fully understand all of the sophisticated financial derivatives sold them by foreign financial institutions and thus did not fully realize the extent of the foreign currency exposures they had undertaken. One may thus recognize the need for continuing financial education in the business community of developing and transition economies, as well as more effective supervision of financial institutions, per se.

An additional strategy would be to discourage foreign sources from providing excessive amounts of funds to domestic borrowers. Reducing a surging inflow reduces the probability of a subsequent sudden outflow when market temperament changes. A simple technique in this spirit would be to introduce some uncertainty about the future price of foreign exchange, as suggested above. There would then be a risk that, say, the extra earnings gained by foreigners in the event that local interest rates were higher than foreign ones, might be lost in the reconversion from local to foreign currency in the event that the exchange rate depreciated. Foreign investors deploying short-term funds would still be permitted to bring their resources to the country, but they would have to accept a higher risk in doing so – or hedge their repurchase through a forward contract that embodied the market's sentiment about the chances of an exchange-rate change – and this would likely reduce the total inflow.

Contribution of international financial cooperation

Developing and transition economies have been the target of the destabilizing short-term financial flows in 1997 and 1998, Latin American countries were the principal victims in 1994 and 1995, and several European countries – including two of the seven major industrialized countries, Italy and the United Kingdom of Great Britain and Northern Ireland – were subject to similar bouts of volatility in 1992. The fact that so many countries, including those with very large economies, can be victims of volatility in such a short time-

[18] A policy in this spirit is the reserve requirement that India imposes on non-resident foreign currency deposits held in Indian banks.

span suggests that the world needs not only policies that protect small countries, but also policies that could reduce the potential for international volatility.

However, it seems that there is no scope to reduce the potential for volatility if one does not simultaneously seek to suppress the rapidly growing and freely flowing volume of international funds and the steadily increasing complexity of the international financial system. Few, if any, Governments appear ready to roll back the international financial integration that has taken place over the past 30 years or so (and few analysts think it could be done even if there were a consensus about doing so). The world thus seems destined to remain vulnerable to financial surges and to speculative attacks on vulnerable currencies.

Rather, Governments of finance-receiving countries can act to make their economies less attractive targets for volatile flows, as discussed above. In addition, Governments of countries supplying and mediating funds to international markets can seek to prevent their financial institutions from taking excessively risky foreign currency positions, thereby reducing the risk of disruption of their domestic financial systems – and, in the case of large financial centres, disruption of the world's financial system. The international community can assist source and recipient countries in this regard, as they work towards stronger standards of prudential oversight for international finance.[19] Finally, the international community needs to offer adequate assistance to countries that fall victim to volatility shocks, as the setback to development and economic transition and the political and social cost of the economic contraction that usually follows the shock can be quite severe, as we have been reminded recently.

As regards the regulatory needs in source countries, a variety of measures might be discussed and many already are under discussion. First, the widely accepted – but decade-old – capital standards of the Basle Committee on Banking Supervision might be reviewed to see if stricter reserve requirements need to be placed against the credit and market exposures of banks. The Basle requirements were designed as minimum standards that could be applied to commercial banks across countries in a comparable way. However, the Basle standards embody complex and contentious issues that required difficult and protracted negotiations before agreement was reached. Indeed, in the view of some in the international banking industry, the current standards are stricter than required under modern methods of risk management. Adequate prudential standards for the regulation of non-bank financial institutions are an additional concern.

Regulators in their international discussions have increasingly sought to use market discipline as their ally, in view of the complexity and quick changes in financial institution exposures. This raises another issue in respect of attempting to control risk, that is to say, satisfying regulators is only part of the challenge facing private financial institutions. They also have obligations to their shareholders and depositors and the string of notable bank failures in developed as well as in developing countries in recent years underline the need for many institutions to strengthen their internal risk measurement and control systems. Managing risk in large financial institutions that create and trade complex financial instruments, as well as take positions in a variety of currencies, is an extremely difficult responsibility to carry out. Systems are needed that allow financial institutions to measure not just their aggregate credit exposures, but also, and on a day-to-day basis, their aggregate price and interest rate risks across financial markets. Individual loan officers, currency traders and sector managers do not generally see the overall exposure, which is why internal

[19] Work in this area has already begun, as evidenced by the agreement on Core Principles for strengthening banking supervision and regulation, developed by the Basle Committee. In addition, such issues continue to be discussed both in established international bodies, such as the Basle Committee and IMF, and in ad hoc bodies, such as the Group of 22 (the "Willard Group").

risk management is a separate function of the central management of financial institutions, one that needs to be timely and effective in tempering the enthusiasm of lending personnel when exposure becomes excessive.

At a more aggregate level, the monetary authorities of the major industrialized nations might seek to acquire the capacity to monitor the total market risks that the financial institutions under their jurisdiction take on collectively and then to warn those institutions when these aggregate positions become excessive. In addition, it would also be important to measure and regulate the aggregate market exposures that all of the major private financial institutions together take on vis-à-vis particular areas of the globe. Technically, these are challenging goals for regulatory authorities. Achieving such goals would call for international cooperation of national regulators, which could take place under the auspices of the Bank for International Settlements, the International Monetary Fund (IMF), or perhaps a new institution.[20]

These considerations notwithstanding, it is widely agreed that there will continue to be emergency situations requiring international assistance for which the lead international agency is IMF. Although the Fund has long urged member Governments to come to it for assistance at an early stage in their difficulties, this rarely happens because taking such action is often viewed as an admission that the Government failed its responsibilities in some important sense. In the popular mind, the Fund is also associated with dispensing "bitter medicine" which the population must swallow, while those behind the failed policies, namely individuals and particular interests (so the perception concludes), escape punishment.

The content of Fund programmes is also controversial, especially regarding the broad issues of governance and structural reform that have entered into IMF programmes for Asian countries in the past year (see chap. III). In this regard, it has been proposed that alternative regional arrangements be created to provide policy advice and mutual surveillance in a politically less sensitive setting, as well as financial support. Although such arrangements were originally viewed by some as an effort to circumvent IMF, the international community has still to consider whether or how they might be rethought as cooperative associations that could solve some of the difficulties identified earlier.

Finally, there is the question of the adequacy of the resources available to IMF to carry out its support of crisis management and macroeconomic adjustment. The Board of Governors of IMF has already agreed to provide additional resources to the Fund, although implementation has been held up mainly because approval by the legislature of the largest shareholder has been delayed. Further increases in resources would be needed, however, if the $110 billion worth of funds for the Asian countries in 1997 and 1998 were to be a guide to future requirements. The funds for those programmes were quickly pulled together from a variety of unscheduled loans by multilateral development banks and individual Governments on ad hoc bases. This was seen to be an emergency response to an emergency situation. It is not clear how often – in any event, certainly not on a routine basis – such a response could readily be repeated.

On the other hand, the need for IMF resources depends on the extent to which the financing needs of a country in crisis have to be filled by the international community. Some have argued that emergency financing has largely covered private capital flight and the

[20] For example, the Minister of Finance of Canada proposed establishing an international supervisory surveillance secretariat on 15 April 1998 at the meetings in Washington, D.C. of the Interim and Development Committees of IMF. The primary concern of Canada was to establish a specific forum for regulatory and supervisory surveillance, through, for example, "peer review" of domestic supervisors and through close work with IMF and the World Bank.

withdrawal of foreign banks. An alternative strategy that requires less funding by official sources involves trying to "bail in" the creditors, including those still seeking a quick exit from the country in crisis. One such method might be to officially countenance a moratorium on debt-servicing or a unilateral reduction in debt-servicing payments, while negotiating debt rollovers and concerted debt workouts. Not surprisingly, views differ on this approach and warrant further international discussion.[21]

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[21] A report to Ministers and Governors, prepared under the auspices of the Deputies of the Group of Ten, considered temporary suspensions of debt-servicing payments and the possibility of IMF agreement to lend to a country that was accumulating arrears to its creditors (see Group of Ten, *The Resolution of Sovereign Liquidity Crises*, May 1996 (available from the Bank for International Settlements and IMF); see also, Richard Portes and David Vines, *Coping with International Capital Flows*, Commonwealth Secretariat, Economic paper, No. 30 (April 1997), pp. 37-41).